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Trust =

A =

B =

State =

D1 =

D2 =

D3 =

D4 =

a =

b =

c =

Dear :

This responds to a letter dated March 17, 2004, and subsequent correspondence submitted on behalf of Trust by its authorized representative, requesting rulings under §§ 664, 507, 1001, and 4941 of the Internal Revenue Code.

The information submitted states that A created Trust, a charitable remainder unitrust (CRUT), on D1. A and A's spouse, B, are entitled to receive payments of the unitrust amounts under the trust instrument. The trust instrument provides that the trustee will pay to A and B, for their concurrent and consecutive lifetimes, a unitrust amount equal to the lesser of: (a) the trust income for the taxable year, as defined in § 643(b) and the regulations thereunder, or (b) a% percent of the net fair market value of the assets of the trust valued as of the first day of each taxable year of the trust (the

valuation date). Upon the death of A or B, the entire unitrust amount is to be paid to the survivor. The payments of the unitrust amounts shall also include any amount of trust income for the year that is in excess of the amount required under (b) above to the extent that the aggregate of the amounts paid in prior years was less than the aggregate of the amounts computed at a% percent of the net fair market value of the trust assets. A is currently the sole trustee of Trust.

Upon the death of the survivor, the trustee shall distribute all of the principal and income of Trust to a charity or charities described in §§ 170(b)(1)(A), 170(c), 2055(a), and 2522(a) designated by A. A has not irrevocably designated any charity as remainderman. If A has not made a designation before A's death, then B shall make the designation.

A and B propose to terminate Trust. A, as trustee, will make a one-time lump sum distribution to A, B, and public charities designated by A equal to the present value of their respective interests effective on the date of termination. A represents that this early termination is allowable under State law.

A's date of birth is D2 and A is aware of no physical condition that would decrease A's normal life expectancy. A's personal physician submitted a statement confirming that there was no indication that A's life expectancy was less than would otherwise be expected for a person A's age. B's date of birth is D3 and B is aware of no physical condition that would decrease B's normal life expectancy. B's personal physician submitted a statement confirming that there was no indication that B's life expectancy was less than would otherwise be expected for a person B's age.

RULING 1

Section 664(d)(2) defines a CRUT for the purposes of § 664 as a trust (A) from which a fixed percentage (which is not less than 5 percent nor more than 50 percent) of the net fair market value of its assets, valued annually, is to be paid, not less often than annually, to one or more persons (at least one of which is not an organization described in § 170(c) and, in the case of individuals, only to an individual who is living at the time of the creation of the trust) for a term of years (not in excess of 20 years) or for the life or lives of such individual or individuals, (B) from which no amount other than the payments described in § 664(d)(2)(A) and other than qualified gratuitous transfers described in § 664(d)(2)(C) may be paid to or for the life or lives of such individual or individuals, (C) following the termination of the payments described in § 664(d)(2)(A), the remainder interest in the trust is to be transferred to, or for the use of, an organization described in § 170(c) or is to be retained by the trust for such a use or, to the extent the remainder interest is in qualified employer securities (as defined in § 664(g)(4)), all or part of such securities are to be transferred to an employee stock ownership plan (as defined in § 4975(e)(7)) in a gratuitous transfer (as defined by § 664(g)), and (D) with respect to each contribution of property to the trust, the value

(determined under § 7520) of such remainder interest in such property is at least 10 percent of the net fair market value of such property as of the date such property is contributed to the trust.

Section 664(d)(3) provides that, notwithstanding the provisions of §§ 664(d)(2)(A) and (B), the trust instrument of a CRUT may provide that the trustee shall pay the income beneficiary for any year (A) the amount of the trust income, if such amount is less than the amount required to be distributed under § 664(d)(2)(A), and (B) any amount of the trust income which is in excess of the amount required to be distributed under § 664(d)(2)(A), to the extent that (by reason of § 664(d)(3)(A)) the aggregate of the amounts paid in prior years was less than the aggregate of such required amounts.

Based solely on the facts and representations submitted, we conclude that the early termination of Trust allowed by State law will not cause Trust to be disqualified as a CRUT under § 664. This ruling is conditioned on A, B, and Trust treating the early termination as described in rulings 2 through 4, below.

RULINGS 2 & 3

Section 507(c) imposes a tax on a private foundation under certain circumstances.

Section 507(d)(2)(A) defines the term “substantial contributor” to include, in the case of a trust, the creator of the trust.

Section 664(c)(1) generally exempts CRUTs, as defined in §§ 664(d)(2) and (3) above, from income tax.

Section 4941(a)(1) imposes an excise tax on disqualified persons for each act of self-dealing between a disqualified person and a private foundation.

Section 4941(d)(1) defines self-dealing as including any direct or indirect sale or exchange, or leasing of property between a private foundation and a disqualified person, or transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation.

Section 4946(a)(1) provides that for purposes of subchapter A of chapter 42 of subtitle D of title 26, the term “disqualified person” includes, with respect to a private foundation, a person who is a substantial contributor to the foundation, or a foundation manager (within the meaning of § 4946(b)(1)).

Section 4946(a)(2) provides that for purposes of § 4946(a)(1), the term “substantial contributor” means a person who is described in § 507(d)(2).

Section 4946(b) provides that for purposes of subchapter A of chapter 42 of subtitle D of title 26 the term “foundation manager” means, with respect to any private foundation: (1) an officer, director, or trustee of a foundation (or an individual having powers or responsibilities similar to those of officers, directors, or trustees of the foundation, and (2) with respect to any act (or failure to act), the employees of the foundation having authority or responsibility with respect to such act (or failure to act).

Section 4947(a)(2) provides, in pertinent part, that in the case of a trust which is not exempt from tax under § 501(a), not all of the unexpired interests of which are devoted to charitable purposes, and which has amounts in trust for which a charitable deduction was allowed, §§ 507 and 4941 apply as if such trust were a private foundation.

Section 4947(a)(2)(A) provides that § 4947(a)(2) shall not apply with respect to any amounts payable under the terms of such trust to non-charitable income beneficiaries.

Section 53.4947-1(c)(2)(ii) of the Foundation and Similar Excise Taxes Regulations provides, in essence, that payments of income by a CRUT to its individual income beneficiaries do not result in any tax on self-dealing under § 4947.

Section 1.7520-3(b)(1)(ii) of the Income Tax Regulations provides that the standard § 7520 annuity, life estate, or remainder factor may not be used to value a restricted beneficial interest. However, a special factor may be used to value a restricted beneficial interest in some circumstances. Section 1.7520-3(b)(1)(i)(C) provides that the standard factor for an ordinary remainder interest represents the present worth of the right to receive \$1.00 at the end of a defined period. Section 1.7520-3(b)(1)(i)(B) provides that the standard factor for an ordinary life estate interest represents the right to receive the use of \$1.00 for a defined period.

Trust is a split-interest trust described in § 4947(a)(2). By being described in § 4947(a)(2), Trust is subject to the provisions of §§ 507 and 4941 and certain other provisions, as if it were a private foundation.

A and B are disqualified persons with respect to Trust within the meaning of § 4946(a)(1)(A). Section 507(d)(2) defines the term “substantial contributor” to include the creator of the trust.

By early termination, Trust will distribute lump sums to A, B, and the charities, equal to the actuarial value of their interests in Trust (taking into account the net-income and make-up provisions of Trust), and the distributions are also treated as a constructive sale or exchange between A, B, and the charities.

Generally, payments to A and B from Trust would constitute self-dealing. However, because the distribution to A and B equals the actuarial value of the income interest, taking into account the net-income provisions of the trust, the exception to self-

dealing provided by § 53.4947-1(c)(2)(i) applies and the distribution will not be an act of self-dealing. Furthermore, because the designated charities are public charities, § 4941 does not apply to the transaction between A, B, and the charities.

The appropriate calculation of the actuarial value of the income interest of Trust, taking into account the net-income provisions of Trust, requires the use of a reasonable method for the calculation which does not inappropriately inflate A and B's interest to the detriment of the charitable remaindermen.

One reasonable method to calculate the actuarial value of the income and remainder interests is the following: the computation of the remainder interest is found using a special factor as indicated in § 1.7520-3(b)(1)(ii). The special remainder factor is found by using the methodology stated in § 1.664-4 for computing the factor for a remainder interest in a unitrust, with the following modification: where § 1.664-4(a)(3) provides an assumption that the trust's stated payout percentage is to be paid out each year, instead the assumed payout shall be that of a fixed percentage which is equal to the lesser of the trust's stated payout percentage or the § 7520 rate for the month of termination. The special factor for the non-charitable payout interest is 1 minus the special remainder factor.

Based on this methodology, the calculation of A's income interest in Trust may be demonstrated as follows: the § 7520 rate for D3 is b percent. Assuming the termination occurred on D3, the lesser of this rate and Trust's stated payout percentage is b percent. A and B's assumed ages as of their nearest birthdays are both c. Based on Table 90CM, interest at b percent, an unadjusted payout rate of b percent, and quarterly payments made at the end of each quarter, the present value of the remainder interest in a unitrust which falls in at the death of the last of two persons aged c is \$0.31362 for each \$1.00 of the trust estate. The present value of the payout interest in the same unitrust until such death is \$1.00 minus \$0.31362, or \$0.68638 for each \$1.00 of the trust estate.

In this case, the income beneficiaries are not expected to receive more than they would during the full term of the trust under the above-described methodology for valuing their interest in a CRUT with a net income make-up feature. Further, it is represented that State law allows for early termination under the facts presented.

In addition, A and B's personal physicians have conducted a physical examination of A and B and have stated that they find no medical condition expected to result in a shorter-than-average longevity (under § 1.72-9). A and B have each signed a similar statement under penalties of perjury.

Furthermore, because the effect of the transaction is to vest the income interest and remainder interest in the remainder beneficiaries, Trust no longer will be a split-interest trust under § 4947(a)(2) and § 507 will not apply.

Accordingly, we hold as follows: the proposed early termination of Trust will not be subject to termination tax under § 507(a) and will not constitute an act of self-dealing under § 4941(d) as to A and B or as to Trust using the methodology described above for the date of termination.

RULING 4

Section 1001(a) provides that the gain from the sale or other disposition of property is the excess of the amount realized therefrom over the adjusted basis provided in § 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

Section 1001(b) states that the amount realized from the sale or other disposition of property is the sum of any money received plus the fair market value of the property (other than money) received. Under § 1001(c), except as otherwise provided in subtitle A, the entire amount of gain or loss, determined under § 1001, on the sale or exchange of property shall be recognized.

Section 1001(e)(1) generally provides that in determining gain or loss from the sale or disposition of a term interest in property, that portion of the adjusted basis of the interest which is determined under § 1014 or § 1015 (to the extent that the adjusted basis is a portion of the entire adjusted basis of the property) shall be disregarded. Section 1001(e)(2) defines a term interest in property to include an income interest in a trust. However, § 1001(e)(3) states that the term interest rule described in § 1001(e)(1) shall not apply to a sale or other disposition of property that is a part of a transaction in which the entire interest in property is transferred to any person or persons.

Section 1.1001-1(f)(1) provides that, for purposes of determining the gain or loss from the sale or other disposition of a term interest in property, a taxpayer shall not take into account that portion of the adjusted basis of such interest which is determined pursuant to § 1015 (relating to the basis of property acquired by gift or by a transfer in trust), to the extent that such adjusted basis is a portion of the adjusted uniform basis of the entire property (as defined in § 1.1014-5).

Section 1.1001-1(f)(3) states that the exception in § 1001(e)(3) applies when the entire interest in property is sold or otherwise disposed of as part of a single transaction to a third person or persons.

Section 1015(b) provides that if property is acquired by a transfer in trust (other than by a transfer in trust by a gift, bequest, or devise), the basis shall be the same as it would be in the hands of the grantor increased by the amount of gain or decreased in the amount of loss recognized to the grantor on the transfer.

Section 1.1015-2(a)(2) provides that the principles stated in § 1.1015-1(b) apply in determining the basis of property where more than one person acquires an interest in property by transfer in trust. Section 1.1015-1(b) provides that property acquired by gift has a uniform basis, and that the proportionate parts of that basis represented by the interests of the life tenant and remainder interest holder are determined under rules provided in § 1.1014-5. However, see §§ 1001(e)(1) through (3), discussed above.

Section 1222(3) provides that the term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than one year. Section 1221(a) defines the term "capital asset" as property held by the taxpayer with certain listed exceptions not applicable here. Section 1223(2) provides that in determining the period for which a taxpayer has held property however acquired there shall be included the period for which the property was held by any other person, if the property has the same basis in the taxpayer's hands as it would have in the hands of that other person.

Rev. Rul. 72-243, 1972-1 C.B. 233, provides that the proceeds received by the life tenant of a trust, in consideration for the transfer of the life tenant's entire interest in the trust to the holder of the remainder interest, are treated as an amount realized from the sale or exchange of a capital asset under § 1222. The right to income for life from a trust estate is a right in the estate itself. See McAllister v. Commissioner, 157 F.2d 235 (2d Cir. 1946), *cert. denied*, 330 U.S. 826 (1947).

Although the proposed transaction takes the form of a distribution of the present values of the respective interests of A, B, and the charities, in substance it is a sale of A and B's interest to the charities. The amount received by A and B as a result of the termination of Trust is an amount received from the sale or exchange of a capital asset. Under § 1015(b), A and B's basis in the life estate is a portion of the entire basis of the property, and the disposition of A and B's interest is not part of a transaction in which the entire interest in Trust is transferred to a third party. Therefore, under § 1001(e), A and B's adjusted basis in their interest is disregarded. A and B's holding period in the life interest exceeds one year. Accordingly, under § 1222(3), the entire amount realized by A and B as a result of the early termination of Trust will be long-term capital gain.

This ruling is conditioned on any assets distributed in-kind from Trust being distributed on a pro-rata basis between A, B, and the charities.

Except as specifically ruled above, we express no opinion concerning the federal tax consequences of the transactions described above under any other provisions of the Code. Specifically, no opinion is expressed as to whether Trust otherwise qualifies as a charitable remainder unitrust under § 664.

This ruling is directed only to the taxpayer that requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Pursuant to a power of attorney on file with this office, a copy of this letter is being sent to Trust's authorized representative.

Sincerely,

J. THOMAS HINES
Chief, Branch 2
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures: 2
Copy of this letter
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